86-1054

No. 86-

Supreme Court, U.S.
FILED
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JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

ASPHALT PRODUCTS CO., INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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QUESTION PRESENTED

Under Section 446(b) of the Internal Revenue Code, is the legal standard for determining if a taxpayer's method of accounting "clearly reflects income" whether the method has been fairly and honestly applied or whether the method yields substantially the same result as that chosen by the Commissioner of Internal Revenue?

PARTIES TO THE PROCEEDING

All the parties in this proceeding are named in the caption of the case. The Petitioner, Asphalt Products Co., Inc., has no subsidiaries and no parent corporation.

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No. 86-

ASPHALT PRODUCTS CO., INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

OPINIONS BELOW

The opinion of the Sixth Circuit Court of Appeals in this case is reported at 796 F.2d 843 (6th Cir. 1986) and is set forth in its entirety in the Appendix hereto at 4a-25a. The opinion of the Tax Court, affirmed in part, reversed in part and remanded by the Sixth Circuit is reported as J. Clark Akers, III and Eleanor M. Akers, et. al v. Commissioner, 47 T.C.M. 1621-39. It is set forth in relevant part in the Appendix at 28a-38a.

GROUNDS FOR JURISDICTION

The decision sought to be reviewed herein was entered by the United States Court of Appeals for the

Sixth Circuit on July 17, 1986, and judgment was entered on that date. An order denying a rehearing was entered by the Court of Appeals on September 25, 1986. In accordance with 28 U.S.C. §2101(c), this petition was filed within ninety days of the date on which the order denying rehearing was entered. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTES INVOLVED

The following sections of the Internal Revenue Code of 1954 ("I.R.C."), as amended, 26 U.S.C. and 26 C.F.R., promulgated pursuant thereto, in effect for the tax years in question, are relevant to the issues presented in this petition:

I.R.C. §446 provides:

> (a) **General Rule.** Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
>
> (b) **Exceptions.** If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary does clearly reflect income.
>
> (c) **Permissible Methods.** Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—
>
> (1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

26 C.F.R §1.446-1(b)(1) provides:

(b) Exceptions. (1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

26 C.F.R. §1.446-1(c)(2) provides:

(i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

(ii) No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deduction are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in this part if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by

> the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method.

26 C.F.R. §1.471-1 provides:

> In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.

STATEMENT OF THE CASE

On March 23, 1978, the Commissioner of Internal Revenue ("Commissioner") issued a statutory Notice of Deficiency proposing adjustments to the taxable income of Asphalt Products Co. Inc. ("Asphalt Products" or "Petitioner"). Asphalt Products timely filed a petition with the United States Tax Court ("Tax Court") which had jurisdiction over the matter pursuant to I.R.C. §§6213, 7442[1]. The Tax Court tried the action on January 28, 1982 on stipulations, oral proof, and documentary evidence. The Tax Court sustained the Commissioner's adjustments compelling Asphalt Products to compute income on the accrual basis rather than the cash basis and applying the negligence penalty pursuant to I.R.C. §6653(a). Asphalt Products appealed the Tax Court's judgment to the Court of Appeals for the Sixth Circuit. The Sixth Circuit upheld the Tax Court in affirming the tax deficiency

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

based on the Commissioner's determination that the taxpayer was required to change its method of accounting from the cash basis to the accrual method, but reversed the Tax Court as to the negligence penalty issue. Both the taxpayer and Commissioner petitioned the Sixth Circuit for rehearing, but the Court denied these petitions by order entered September 25, 1986.

The issue raised in this Petition for Certiorari is in respect to the Sixth Circuit's affirmation of the Commissioner's determination that a change in accounting methods was required by Asphalt Products. The change ordered by the Commissioner to the accrual method resulted in an increase in taxable income and additional tax due.

Prior to the Commissioner's determination, Asphalt Products had consistently maintained its books and reported its taxable income on the cash receipts and disbursements method. It reports on a calendar year basis. The company manufactures and sells emulsified asphalt. There is little or no demand for emulsified asphalt during the winter months and the nature of the product prohibits storing it during that time. T.C. at 31a.[2] As a result, the company never maintained any inventory of finished product at the close of its annual accounting period. For the same reason the company ordinarily carried no inventory of raw material over from one year to the next. T.C. at 31a.

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[2] All references to the Sixth Circuit Opinion shall be cited as Ct. App. at 4a. All references to the Tax Court opinion shall be cited as T. C. at 28a. The page references are to the opinions as they appear in the Appendix hereto.

However, when oil products were allocated beginning with the oil embargo in 1973 Asphalt Products was forced to acquire some fuel oil in December in order to avoid losing its allocation. T.C. at 31a. At all times before and after the 1973 oil embargo the company held no year end inventory of fuel oil.

The oil embargo also caused a decline in gasoline tax revenues which Tennessee counties collected on a per gallon basis. T.C. at 32a. These counties were the company's principal customers. Simultaneously the embargo more than doubled the price of emulsified asphalt which is made from oil derivatives. The combination of accelerating costs and declining revenues caused many counties to fall behind in their payments to Asphalt Products. The company's accounts receivable ballooned. T.C. at 32a. (Cash basis income remained relatively stable because the company collected a $300,000 judgment in 1974 which had been disputed since 1967.) As a result of the dramatic increase in accounts receivable, 1974 income determined on the accrual basis materially exceeded 1974 cash basis income.

The Sixth Circuit based its opinion on its determination that the Commissioner did not abuse his discretion in finding that the cash method of accounting no longer clearly reflected the taxpayer's income. In reaching this conclusion, the Court of Appeals adopted an interpretation of the word "clearly" as used in §446 which holds that "clearly" means "accurately," not just "fairly and honestly." The Sixth Circuit held that "where the Commissioner has determined that the accounting method used by a taxpayer does not clearly reflect income, in order to prevail, 'the taxpayer must demonstrate substantial

identity of results between his method and the method selected by the Commissioner.' " Ct. App. at 14a, *citing Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d 352, 356 (1st Cir. 1970)

Because of a clear conflict in the interpretation of §446(b) by the Circuit Courts of Appeals, and because of the importance of this question of federal tax law, especially in view of the pending changes regarding the choice of accounting methods to be implemented with the Tax Reform Act of 1986, Petitioners seek review of the Sixth Circuit decision on the construction and application of §446(b) and the Treasury Regulations thereunder.

REASONS FOR GRANTING THE PETITION FOR WRIT OF CERTIORARI

This case is ripe for Supreme Court review to resolve a conflict between the Circuit Courts of Appeals in the construction of an important question of federal tax law regarding the standard to be applied in determining whether a method of accounting is permissible for a particular taxpayer.

The Sixth Circuit's construction of "clearly" in §446(b) as meaning "accurately" is in direct conflict with the so called "fairly and honestly" interpretation used by the Ninth Circuit. *Osterloh v. Lucas*, 37 F.2d 277, 278-279 (9th Cir. 1930). In addition, the Sixth Circuit's adoption of "clearly" as meaning "accurately" is in direct conflict with three prior decisions of the Sixth Circuit. *Morris-Poston Coal Co. v. Commissioner*, 42 F.2d 620 (6th Cir. 1930); *Huntington Securities Corp. v.Busey*, 112 F.2d 368 (6th Cir. 1940); *Glenn v. Kentucky Color & Chemical Co.*, 186 F.2d 975 (6th Cir. 1951). In its opinion, the Sixth Circuit

attempted to distinguish these prior decisions, but the court adopted a standard in interpreting §446(b) which is in direct conflict with these prior decisions without expressly overruling them.

Even if the Sixth Circuit had overruled its prior decisions, this case is ripe for review in order to clarify the proper construction of §446(b) given the conflict between the Circuit Courts of Appeals and the importance of this question in the scheme of federal taxation of business enterprises. Congress allows a taxpayer to choose between the cash and accrual methods of accounting as long as the method chosen is consistently used and clearly reflects income. In §801 of the Tax Reform Act of 1986, Congress retained cash basis accounting for small businesses. This clearly evidences Congress's intent to allow cash basis accounting by small businesses. Under the construction of §446 utilized in the Sixth Circuit's opinion below, virtually no business could qualify to use the cash basis method of accounting. If upheld, this standard would frustrate Congressional intent, and could force all businesses to use accrual accounting at the unbridled discretion of the Commissioner.

THE COURT BELOW DECIDED AN IMPORTANT QUESTION OF FEDERAL LAW WHICH NEEDS TO BE SETTLED BY THIS COURT.

A. Introduction

§446(a) provides that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." §446(c) expressly allows a taxpayer to report income on either the cash or accrual basis, but subject to the Commissioner's power under

§446(b) to compel the use of a method other than the one chosen by the taxpayer were necessary to "clearly reflect income." §446(b). Thus, under §446, a taxpayer is allowed to report taxable income on the cash or accrual basis unless either no method of accounting has been regularly used by the taxpayer or the method used does not "clearly reflect income." §446(b). The Treasury Regulations under §446 generally follow the provisions in the law, but additionally provide some special rules regarding methods of accounting for taxpayers who use inventory in the production of income. These special rules are contained in Treasury Regulation §1.446-1(c)(2)(i), (ii)[3] and provide that taxpayers who must use inventories are required to report on the accrual basis unless the Commissioner allows the use of a different method.

Literally applied, the regulations would prevent the continued use of the cash method of accounting by a taxpayer who ever needs inventory unless such continued use of the cash method was authorized by the Commissioner. The statute itself allows the taxpayer to use the cash method of accounting as long as the taxpayer has consistently used this method of accounting or unless this method does not "clearly reflect income." §446(b). In order to bring Treas. Reg. §1.446-1(c)(2)(i), (ii) within the express terms of the statute, these regulations must be construed to mean that a taxpayer who has inventory may continue to report income on the cash basis so long as this method "clearly reflects income."

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[3] All citations to sections in the Treasury Regulations are to 26 C.F.R. unless otherwise indicated.

Thus the critical issue in this case is the determination as to whether the Petitioner's reporting of its income on the cash basis during the years at issue "clearly reflects income." In order to make this determination, this Court must construe the term "clearly" within the meaning of §446(b).

B. §446 and the Commissioner's Discretion.

As this Court has noted, the Commissioner has wide discretion in determining whether a particular method of accounting "clearly reflects income." *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979). Petitioner does not dispute this, but the Commissioner's discretion cannot extend beyond the limits of the law. The Commissioner's interpretation of a statute should be upheld as long as it harmonizes with the plain language of the statute, its origin and its purpose. *Strick Corp. v. United States*, 714 F.2d 1194 (3rd Cir. 1983), *cert. denied* 104 S. Ct. 2345.

Under §446 a taxpayer is allowed to report under the cash method of accounting, if this method is consistently used and income is clearly reflected. If the requirement that the method of accounting must clearly reflect income is absolute,

> it is safe to say that books kept on the basis of cash received and disbursed will rarely, if ever, reflect the true income, because nearly always at the end of the tax year accounts due the taxpayer will remain uncollected and some of his own obligations will remain unpaid.

Osterloh v. Lucas, 37 F.2d 277, 278 (9th Cir. 1930). In order to give §446 internal consistency, the re-

quirement that income be clearly reflected must be read in conjunction with the express allowance of the cash method of accounting for reporting taxable income. Under this scheme, "clearly" cannot mean "precisely" but instead must be given its normal connotation: plainly, honestly, straight forwardly and frankly." *Huntington Securities Corp. v. Busey*, 112 F.2d 368, 370 (6th Cir. 1940).

Although the provisions found in §446 have been a part of the tax laws since the Revenue Act of 1918, this Court has never interpreted the meaning of "clearly reflects income." Numerous decisions of this Court have upheld the Commissioner's discretion in requiring a change in accounting methods,[4] but the Court has not adopted any legal standard for determining whether or not a taxpayer's method of accounting "clearly reflects income." The proper legal standard is needed in order to guide the lower courts in their review of determinations by the Commissioner that a change in accounting methods is required.

In §801 of the Tax Reform Act of 1986, Congress has changed the rules regarding permissible methods of accounting. Under the new law, cash basis accounting can only be used by individuals and by corporations with gross receipts of less than $5 million a year. Thus under the new rules, a corporation with gross receipts of $4 million a year could use the cash method basis of accounting as long as this method clearly reflected its income. Given the nature of the cash basis method of accounting, it would be virtually

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[4] See *Thor Power Tool Co v. Commissioner*, 439 U.S. 522, 532 (1979) for a list of citations on this issue.

impossible for a corporation with $4 million of gross receipts per year to have a complete matching of income and expenses as reported on the cash basis. If "clearly reflects income" means "accurately," and that "the taxpayer must demonstrate substantial identity of results between his method and the method selected by the Commissioner," Ct. App. at 14a, *citing Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d 352, 356 (1st Cir. 1970), then it is safe to say that a business of any size would not qualify to use the cash method of accounting. In addition, even individuals who have accrued income and expenses at the end of the year would not be able to use the cash method of accounting if the Sixth Circuit's interpretation of §446 is upheld. A more logical interpretation of §446, one which is consistent with the internal scheme of §446 as well as the new provisions added by the Tax Reform Act of 1986, is that "clearly reflects income" means only that the taxpayer's method of accounting fairly, honestly, and without manipulation reflects his income.

THE DECISION BELOW IS IN DIRECT CONFLICT WITH DECISIONS RENDERED BY THE NINTH CIRCUIT AND THE TAX COURT ON THE SAME ISSUE.

Judicial precedent has developed two separate and distinct standards for determining when a method of accounting clearly reflects income. The earliest standard is exemplified by the decision of the United States Court of Appeals for the Ninth Circuit in *Osterloh v. Lucas*, 37 F.2d 277 (9th Cir. 1930). *Osterloh* and the cases which have followed it including *Huntington Securities Corp. v. Busey*, 112 F.2d 368 (6th Cir. 1940)

and *Glenn v. Kentucky Color & Chemical Co., Inc.*, 186 F.2d 975 (6th Cir. 1951) hold that:

> In our opinion, all that is meant [by the requirement that a method of accounting clearly reflect income] is that the books shall be kept fairly and honestly; and when so kept, they reflect the true income of the taxpayer within the meaning of the law. In other words, the books are controlling, unless there has been an attempt of some sort to evade the tax.

Osterloh v. Lucas, 37 F.2d 277, 278-9 (9th Cir. 1930). Under the *Osterloh* standard, the cash method of accounting will clearly reflect income notwithstanding large fluctuations in accrual items, so long as those fluctuations are not deliberately generated by the taxpayer to reduce his tax liability or delay taxation.

The alternative standard is found in *Caldwell v. Commissioner of Internal Revenue*, 202 F.2d 112 (2nd Cir. 1953) where the United States Court of Appeals for the Second Circuit expressly criticized the *Osterloh* decision:

> While the taxpayer's honesty and good faith have not been in the slightest impugned in the present case, we read "clearly reflect the income" in I.R.C. §41 to mean rather that income should be reflected with as much accuracy as standard methods of accounting practice permit.

Caldwell at 115.

Although the *Caldwell* standard has become the majority view, this approach is difficult to reconcile with

the statutory scheme of §446. Under the statute, the cash basis method of accounting is acceptable for reporting taxable income as long as it clearly reflects income. If Congress intended "clearly" to mean "accurately," then it is unlikely that the cash basis method of accounting could ever be used. For, as the Ninth Circuit noted in *Osterloh*

> it is safe to say that books kept on the basis of cash received and disbursed will rarely, if ever, reflect the true income, because nearly always at the end of a tax year, accounts due the taxpayer will remain uncollected and some of his own obligations will remain unpaid.

Osterloh at 278. By expressly allowing the use of the cash method of accounting, Congress must have intended that "clearly" mean, in the words of the Sixth Circuit in *Huntington Securities*, "plainly, honestly, straightforwardly and frankly, but does not mean 'accurately' which, in its ordinary use, means precisely, exactly, correctly, without error or defect." 112 F.2d at 370.

This Court has never endorsed either of these interpretations of §446. A clear conflict between the Circuit Courts of Appeals exists and this conflict has led to conflicting decisions in the Tax Court. *Compare* T.C. at 28a *with Magnon v. Commissioner*, 73 T.C. 980, 1046 (1981). This conflict between the Circuit Courts of Appeals and between various lower courts is on an issue which potentially affects every taxpayer. Each taxpayer must report his taxable income using his chosen method of accounting. With two conflicting standards, taxpayers cannot properly evaluate

whether their particular method complies with the requirements of §446. This Court should address this issue and determine the proper standard to be used in evaluating compliance with §446.

THE SIXTH CIRCUIT'S OPINION DIRECTLY CONFLICTS, WITHOUT OVERRULING, DECISIONS IT HAD PREVIOUSLY RENDERED ON THE SAME ISSUE.

In its opinion, the Sixth Circuit adopts a standard interpreting §446(b) which is in direct conflict with the interpretation of this section it had announced in three prior decisions. In both *Glenn v. Kentucky Color & Chemical Co.*, 186 F.2d 975 (6th Cir. 1951) and *Huntington Securities Corp. v. Busey*, 112 F.2d 368 (6th Cir 1940), the Sixth Circuit expressly adopted the standard for interpreting "clearly" under §446(b) which had first been pronounced by the Ninth Circuit in *Osterloh*. "The statute requires only that the taxpayer's books shall be kept fairly and honestly, without any attempts to evade the tax. *Kentucky Color* at 977 *citing Osterloh v. Lucas*, 37 F.2d 277 (9th Cir. 1930).

> "Clearly," as used in the statute, means plainly, honestly, straightforwardly and frankly, but does not mean "accurately" which, in its ordinary use, means precisely, exactly, correctly, without error or defect.

Huntington Securities at 370.

In *Morris-Poston Coal Co. v. Commissioner*, 42 F.2d 620 (6th Cir. 1930), while it did not expressly adopt the *Osterloh* decision (which had been issued only earlier that year), the Sixth Circuit based its opinion on an interpretation of "clearly reflects income" quite

similar to that announced in *Osterloh*. In Morris-Poston, the Commissioner assessed a deficiency based on his determination that a rental payment for the six month period ended December 31, 1921 should be included in the taxpayer's 1921 income although it was not paid until January of 1922.

The taxpayer was on a system of accounting that was essentially the cash basis method with some slight modifications. The Commissioner asserted that in not reporting the rent in its 1921 income it had changed its method of accounting. The court rejected this contention and stated that the only basis on which the Commissioner could require the taxpayer to accrue this income was if the taxpayer's accounting method did not truly reflect its income. The court held that the method of accounting did truly reflect income and noted that the approach of the Board of Tax Appeals "would require accounting and income computations upon the accrual basis in all cases and at all times where there are accruals." 42 F.2d at 622. The court found that the taxpayer's method of accounting truly reflected income for the year in question even though there was a large item of accrued but unpaid income at year end which was not reported in that year.

The Sixth Circuit distinguished these prior decisions on the basis that in none of these cases had the Commissioner made a determination that the taxpayer's method of accounting did not clearly reflect income. The significance of this distinction is difficult to discern in view of the court's closing in *Morris-Poston*:

> The facts here are undisputed. The only question is whether the report truly reflected the

> taxpayer's income for 1921; and we think it did.

42 F.2d at 623. Even if this distinction is valid, the cases contain inconsistent and directly contradictory interpretations and applications of §446(b). The familiar principal of *stare decisis* dictates that the Sixth Circuit should either expressly overrule its previous decisions or apply the standards adopted therein to the present case.

In the present case, the Petitioner has consistently kept its books on the cash basis method of accounting. During the tax years in question, due to the Arab oil embargo, Petitioner for the first time had inventory on hand at the end of its tax year and for the same reasons experiencèd approximately a three fold increase in both its accounts receivable and its accounts payable. Ct. App. at 21a. The circumstances giving rise to these conditions were totally beyond Petitioner's control, and it has never been alleged that Petitioner was manipulating or attempting to distort its taxable income. Clearly, Petitioner's reporting of its income by the cash method has been fair, honest, consistent, and straightforward.

Utilizing the cash basis method of accounting, Petitioner reported income on the basis of income actually received and expenses actually paid during the tax year. Like any other business, Petitioner had accrued income which had not been received and accrued expenses which had not been paid at the end of its tax year. The cash basis method of accounting is not designed to match precisely income and expenses during any one period. Petitioner's use of the cash basis method of accounting clearly reflected its

income because this method was consistently used without manipulation.

If the Sixth Circuit's interpretation of §446 stands, the Commissioner will be empowered to demand that virtually all taxpayers using the cash method of accounting change to the accrual method. Such a result is clearly contrary to the statutory scheme of §446 and Congress' recent affirmation of the cash method of accounting as an acceptable option for reporting taxable income.

CONCLUSION

For the foregoing reasons, this Petition should be granted and a Writ of Certiorari should be issued to review the decision below.

Dated: December 23, 1986.

Respectfully submitted,

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APPENDIX

Appendix A

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

No. 84-1882/1841

ASPHALT PRODUCTS CO., INC.,
Petitioner,

J. CLARK AKERS, III, *et al.*,
Petitioners-Appellants, Cross-Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee, Cross-Appellant

FILED
Sep 25 1986

ORDER

BEFORE: LIVELY, Chief Judge, JONES and NELSON, Circuit Judges

The Court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this Court, and no judge of this Court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original hearing panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT
/s/ John Hehman
John P. Hehman, Clerk

Appendix B

United States Court of Appeals
For the Sixth Circuit

No. 84-1841/1882

ASPHALT PRODUCTS COMPANY, INC.,
Petitioner-Appellant, Cross-Appellee,
v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee, Cross Appellant.

Before: LIVELY, Chief Judge; and JONES and NELSON, Circuit Judges.

Filed

Jul 17 1986

JUDGMENT

ON APPEAL from a decision of the Tax Court of the United States.

THIS CAUSE came on to be heard on the transcript of record from the said Tax Court and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed in part, reversed in part, and the case is remanded for further proceedings consistent with this opinion. The cross appeal is dismissed.

No costs taxed.

ENTERED BY ORDER OF THE COURT
John P. Hehman, Clerk

/s/ John P. Hehman
Clerk

A True Copy
Attest:

/s/Tom Bennignus
Deputy Clerk

APPENDIX C

Nos. 84-1841/84-1882

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

ASPHALT PRODUCTS CO., INC.,
Petitioner-Appellant,
Cross-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee,
Cross-Appellant.

} ON APPEAL from the United States Tax Court.

Decided and Filed July 17, 1986

Before: LIVELY, Chief Judge; JONES and NELSON, Circuit Judges.

LIVELY, Chief Judge, delivered the opinion of the Court, in which JONES, Circuit Judge, joined. NELSON, Circuit Judge (pp. 14-22) delivered a separate opinion concurring in part and dissenting in part.

LIVELY, Chief Judge. This tax case presents issues related to the method of accounting employed by a taxpayer and the application of the negligence penalty provided for in section 6653 of the Internal Revenue Code (the Code). 26 U.S.C.

§ 6653 (1982). Asphalt Products Co., Inc. (the taxpayer) appeals from a decision of the United States Tax Court upholding an income tax deficiency assessment by the Commissioner of Internal Revenue (the Commissioner) for 1974. The Tax Court also affirmed the addition of a five percent negligence penalty on the total deficiency. The Commissioner has filed a protective cross-appeal with respect to that portion of the decision of the Tax Court which credited the taxpayer with overpayments of its income taxes for 1975 and 1976. If this court should reverse the finding of a deficiency for 1974 based on the conclusion that the Commissioner erred in requiring the taxpayer to change its method of accounting, it would be necessary to recalculate the taxpayer's income tax liability for 1975 and 1976.

I.

A.

The taxpayer produces and sells emulsified asphalt, a road paving material. Its principal customers are county governments in its general area of Tennessee. The counties share in state gasoline taxes, and these taxes provide the revenues required for road construction and maintenance. The Arab oil embargo of 1973 created a double-barreled problem for the counties. The price of emulsified asphalt, whose principal ingredient is a residue from the refining of oil, rose rapidly, while the consumption of gasoline dropped sharply. Because of this combination of circumstances the taxpayer's accounts receivable increased from $72,000 on January 1, 1974 to $264,000 on the first day of 1975.

The oil embargo had an additional direct effect on the taxpayer's operations. Because emulsified asphalt cannot be used in cold weather, until 1973 the taxpayer never carried any inventory of asphalt or raw materials through the winter. Instead, it finished its run in December and closed its operation down completely for several weeks before the end of the

year. As a result of the embargo, the suppliers of petroleum residue made allocations to their customers and required each to take its allocation every month or lose the right to receive raw materials in subsequent months. After having only nominal ending inventories through 1973, the taxpayer had inventories on hand of $25,800 at the end of 1974 and $36,000 at the end of 1975. When more normal conditions returned, inventories at the end of 1976 fell to $1,583.

B.

From its inception the taxpayer employed the cash receipts and disbursements method of accounting. The Commissioner determined that the cash method did not accurately reflect the taxpayer's income, and assessed a deficiency for 1974 by recomputing the taxpayer's income using the accrual method of accounting. The Commissioner found that the use of inventories was necessary in order to reflect the taxpayer's income accurately, and applied the rule that a taxpayer must use the accrual method of accounting where inventories are a significant income-producing factor. The Commissioner also found that the fluctuations in accounts receivable made use of the cash method inappropriate because its use resulted in a "mismatching" of receipts from sales and cost of sales.

The taxpayer petitioned the Tax Court for redetermination of the deficiency. The Tax Court found that the Commissioner acted properly in requiring the taxpayer to change to an accrual method of accounting, and upheld the deficiency determinations.

C.

The taxpayer claimed a deduction of $1,103 on its 1974 return for the expenses of transporting personal property of two shareholders from California to Tennessee. The taxpayer took delivery of two new trucks in California and sent its drivers there to bring the trucks to Tennessee. The two principal shareholders of the taxpayer had purchased wastewater

treatment plants in California to use in a Tennessee development. The truck drivers hauled the plants to Tennessee, using the new trucks they picked up in California, and the taxpayer deducted the salaries and reimbursed expenditures of the drivers as business expenses.

The taxpayer conceded in the Tax Court that the deduction for salaries and expenses of the drivers was not properly taken. The Commissioner assessed a 5% negligence penalty on the entire deficiency rather than assessing it only on the deficiency resulting from the improper deduction. The penalty exceeded $6,900, though the improperly claimed deduction was only $1,103. The Tax Court affirmed this addition to tax for 1974.

II.

A.

With respect to methods of accounting, § 446 of the Code, in applicable part, provides:

> **§ 446. General rule for methods of accounting**
>
> **(a) General Rule.**—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
>
> **(b) Exceptions.**—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.
>
> **(c) Permissible methods.**—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

> (1) the cash receipts and disbursements method;
>
> (2) an accrual method;
>
> (3) any other method permitted by this chapter; or
>
> (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

26 U.S.C. § 446 (1982). Treasury Regulations follow the statute and permit a taxpayer to compute taxable income under either the cash or accrual method and require that taxable income be computed on the basis of the same method of accounting regularly used in keeping the taxpayer's books. 26 C.F.R. § 1.446-1(a). Reflecting the provisions of Code section 446(b), an exception to this general rule appears in 26 C.F.R. § 1.446-1(b)(1):

> (b) *Exceptions.* (1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

In addition there is a special rule related to inventories in 26 C.F.R. § 1.446-1(c)(2)(i):

> (2) *Special Rules.* (i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

A related regulation describes the conditions under which the use of inventories is necessary:

> In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year

> are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.

26 C.F.R. § 1.471-1.

B.

From the foregoing code provisions and regulations the Commissioner argues that the use of inventories is necessary in order to reflect the taxpayer's taxable income correctly since the production and sale of merchandise is an income-producing factor. The use of inventories being necessary, the accrual method of accounting must be used. Thus, the Commissioner asserts, he did not abuse his discretion in requiring the taxpayer to adopt the accrual method. In the alternative, the Commissioner contends that the presence of a significant amount of accounts receivable in 1974 and subsequent years resulted in a substantial distortion when the cash method of accounting was used. The failure to match sales with the true costs of goods sold produced a return that did not accurately reflect income. Based on the grant of discretion in § 446 of the Code, the Commissioner maintains that he acted properly in requiring the taxpayer to adopt the method of accounting that would "clearly reflect" its income.

The taxpayer contends that the Commissioner abused his discretion. Since the taxpayer had fairly and consistently reported its income for many years on a cash basis and the increase in inventories and accounts receivable resulted from forces over which it had no control, the taxpayer argues that the Commissioner acted arbitrarily. Inventories became "necessary" only by reason of a temporary and "aberrational" condition, not because the ordinary operation of its business required them. Recognizing the fact that the Commissioner has broad discretion to require a change of accounting methods, the taxpayer argues the authority to do so is limited to cases where "the method used does not clearly reflect income," 26 U.S.C. § 446(b), and this is not such a case. The

taxpayer relies on the second "special rule" contained in 26 C.F.R. § 1.446-1(c)(2)(ii):

> No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year.

The taxpayer's argument turns the negative statement of the regulation into a positive rule that *if* all items of gross profit and deductions are treated with consistency from year to year, the method of accounting *must* be regarded as clearly reflecting income.

III.

The Commissioner acts for the Secretary of the Treasury and § 446 of the Code clearly gives the Secretary very broad discretion to require a particular method of accounting. The only limitation on the exercise of this discretion appears to be that the method in use does not clearly reflect income and that a different method is required to do so. However, this preliminary determination is also left to the Commissioner. The Supreme Court has construed § 446 [formerly § 41 of the 1939 Code] as follows:

> The Commissioner has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income. *Lucas v. American Code Co.*, 280 U.S. 445, 449; *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 189-190, and under § 41 of the Internal Revenue Code of 1939, 26 U.S.C. (1952 ed.) § 41, the Commissioner, believing that the accounting method employed by a taxpayer "does not clearly reflect the income," may require that "computation shall be made in accordance with such method as in [his] opinion . . . does clearly reflect the income."

Commissioner of Internal Revenue v. Hansen, 360 U.S. 446, 467 (1959). Thus, § 446 gives the Commissioner discretion

with respect to two determinations. The Commissioner first determines whether the accounting method chosen by a taxpayer clearly reflects income. If the Commissioner concludes that the taxpayer's chosen method does not meet this standard, he has the further discretion to require that computations be made under the method which, in his opinion, does clearly reflect income. It would be difficult to describe administrative discretion in broader terms.

It is the taxpayer's position that the requirement that a method of accounting clearly reflect income is not absolute, in that it does not require an exact matching of receipts from the sale of products with the costs of goods sold. If the requirement were absolute, it contends, the cash receipts and disbursements method of accounting would never be permitted because that method admittedly is inexact. Yet the Code and regulations do recognize and permit use of the cash method. The taxpayer urges us to follow cases which have held that the requirement is not absolute and that the Commissioner exceeds his authority when he insists that a taxpayer change from a method that has been fairly and consistently employed unless there has been some attempt to manipulate records or evade the payment of taxes. In *Osterloh v. Lucas*, 37 F.2d 277, 278-79 (9th Cir. 1930), the court stated:

> In our opinion, all that is meant [by the requirement that the method of accounting shall clearly reflect the income] is that the books shall be kept fairly and honestly; and when so kept they reflect the true income of the taxpayer within the meaning of the law. In other words, the books are controlling, unless there has been an attempt of some sort to evade the tax.

Osterloh has been cited by the Tax Court as stating a general principle, though we have found no case where it has been followed in circumstances like those of the present case.

The taxpayer also relies on two decisions from this court, both of which are distinguishable. In *Morris-Poston Coal Co. v. Commissioner of Internal Revenue*, 42 F.2d 620 (6th Cir. 1930), the Commissioner based a deficiency assessment on his finding that a taxpayer had changed its method of accounting without prior approval. The court concluded that the facts did not support this finding and reversed an order of the Board of Tax Appeals upholding the deficiency assessment. The significant difference between the present case and *Morris-Poston* is that the Commissioner in *Morris-Poston* failed to make a determination that the accounting method employed by the taxpayer did not clearly reflect income. Rather the Commissioner sought to require the taxpayer to accrue rental income on the erroneous finding that the taxpayer had changed its accounting method without prior approval. As the court pointed out, ". . . the right of the commissioner to reject the taxpayer's theory of income in this kind of a case stands upon the Commissioner's preliminary finding that the method employed by the taxpayer did not clearly reflect the income." *Id.* at 621. The authority to require a taxpayer to change its accounting method is not available for enforcement of other Code provisions. It may be used only as provided in § 446, after a determination has been made that the method in use does not clearly reflect income.

Glenn v. Kentucky Color & Chemical Co., 186 F.2d 975 (6th Cir. 1951), may be distinguished on the same basis. The Court in *Kentucky Color* stated:

> The Commissioner does not here assert, and so far as this record shows has never asserted that the taxpayer's method of accounting and reporting its taxes did not clearly reflect its income. He asserts that the method used is the accrual method and that therefore the Commissioner was authorized to order the accrual of the items involved. But the Commissioner's authority to order a change in accounting

> methods when the taxpayer has regularly employed a consistent method depends upon his finding that the taxpayer's method does not clearly reflect the income.

Id. at 977 (citation omitted). The same fact distinguishes *Magnon Service Electric Corp. v. Commissioner of Internal Revenue*, 73 T.C. 980 (1980), a recent decision which cited *Osterloh*. In *Magnon* the Commissioner based a deficiency upon a finding that the taxpayer should have used the percentage of completion method rather than the cash receipts and disbursements method of accounting with respect to long-term construction contracts. The Commissioner made no express determination under § 446 that the cash method of accounting did not clearly reflect income.

In each of the cited cases other than *Osterloh* the courts have concluded that the Commissioner was seeking to exercise a statutory power without making a preliminary determination which the statute establishes as a prerequisite. These cases do not limit the Commissioner's discretion when § 446 is properly applied. Instead, they stand for the proposition that the C nmissioner cannot resort to his § 446 authority to require a change in accounting method just because he disagrees with a taxpayer's choice of method. That is not the situation in the present case. Here the Commissioner concluded that the cash method did not clearly reflect the taxpayer's 1974 income because inventories were a necessary element of its income-producing activities and the presence of substantial accounts receivable at the end of the year meant that the cost of goods sold had been deducted while the proceeds from the sales of these goods had not been included in income. This "mismatching" resulted in reporting that did not clearly reflect income.

When the Commissioner concludes that a taxpayer's method of accounting does not clearly reflect income, the taxpayer has a heavy burden to show that the Commissioner has abused his discretion. A taxpayer does not overcome that

burden by merely showing that it has "fairly and consistently" reported its income in the past. As in the present case, a change in conditions might render the past method of accounting inaccurate. Though the temporary increase in inventory in the present case was not significant, the large increase in accounts receivable created a situation where only use of the accrual method of accounting would avoid a serious distortion. Under these circumstances, the Commissioner's finding that the cash method no longer clearly reflected the taxpayer's income was fully supported by the record and the requirement that the taxpayer adopt the accrual method for 1974 and subsequent years was not an abuse of discretion.

We agree with the court in *Caldwell v. Commissioner of Internal Revenue*, 202 F.2d 112, 114-15 (2d Cir. 1953), where it stated that the requirement that books reflect income "clearly" means "accurately," not just "fairly and honestly." Where the Commissioner has determined that the accounting method used by a taxpayer does not clearly reflect income, in order to prevail, "the taxpayer must demonstrate substantial identity of results between his method and the method selected by the Commissioner." *Wilkinson-Beane, Inc. v. Commissioner of Internal Revenue*, 420 F.2d 352, 356 (1st Cir. 1970).

We realize that the result seems harsh in this case. If the temporary and rather insignificant increase in inventories of raw materials had been the only basis for the Commissioner's determination, we would have been inclined to find an abuse of discretion. We do not construe the Code provisions and regulations relating to inventories in the absolute terms adopted by the Commissioner and the Tax Court. However, the taxpayer's method of accounting did not produce an accurate picture of its 1974 income. The income tax is structured on an annual basis. Using the cash method, the cost of materials sold in 1974 was deducted on the 1974 return, yet the proceeds from that portion of the same sales represented by the accounts receivable were not included in the taxpayer's

gross receipts as reported on its return. Unlike the inventory item, the accounts receivable were not negligible before 1974 and did not shrink even to their former size at the end of the oil emergency. The taxpayer had accounts receivable of $238,000 at the end of 1976. These facts supported the Commissioner's determination that the cash receipts and disbursements method did not clearly reflect the taxpayer's income.

IV.

Section 6653(a) of the Code, in its entirety, provided:

> (a) **Negligence or intentional disregard of rules and regulations with respect to income or gift taxes.**—If any part of any under payment (as defined in subsection (c)(1)) of any tax imposed by subtitle A or by chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

The Commissioner found that the taxpayer acted negligently in claiming a deduction for the cost of transporting the wastewater treatment plants to Tennessee. On the basis of this finding, the Commissioner added a 5% penalty to the entire deficiency assessment. Since the total deficiency assessment was more than $133,000, this resulted in a penalty of $6,943, though the deficiency attributable to the deduction was only the portion of the whole representing the tax on $1,103. The Tax Court upheld the Commissioner, concluding that the Code requires an addition of 5% to the entire underpayment.

There is case law to support the decision of the Tax Court. See *Vnuk v. Commissioner of Internal Revenue*, 621 F.2d 1318 (8th Cir. 1980); *Abrams v. United States*, 449 F.2d 662 (2d Cir. 1971). These cases bear no resemblance to the present case. In both there were egregious attempts to avoid the

payment of taxes and one is left wondering how the taxpayers avoided the 50% fraud penalty imposed by § 6653(b) of the Code. In *Abrams* the taxpayer argued that literal application of § 6653(a) would lead to an absurd result where a "comparatively insignificant item of income is negligently omitted." The court responded:

> That case is not before us on this appeal and we therefore express no opinion whatever as to its proper disposition if it should ever arise.

449 F.2d at 664.

"That case" is now before us. The bulk of the deficiency arose from the taxpayer's consistently following its accounting practices. In contesting the Commissioner's deficiency determinations it relied on decisions of this court that arguably supported its position. The Commissioner did not claim a negligence penalty with respect to the actions of the taxpayer that resulted in all but a few hundred dollars of the $133,000 deficiency assessment. The taxpayer did not concede that it was negligent in claiming the disallowed deduction; it merely conceded that the deduction was erroneously claimed. We will not let the tail wag the dog. "Under all the circumstances of the instant case," *Frederick W. Finney*, T.C. Memo 1980-23, we conclude that the § 6653(a) penalty should be applied only to that portion of the deficiency attributable to the disallowed deduction.

The decision of the Tax Court is affirmed in part, reversed in part, and remanded for further proceedings consistent with this opinion. The cross-appeal is dismissed. No costs are allowed.

DAVID A. NELSON, Circuit Judge, concurring in part and dissenting in part. I concur wholeheartedly in Part IV of the court's opinion. Where the taxpayer is subject to a penalty only because of the negligent omission of a comparatively insignificant item of income, and the Commissioner also asserts that there is a large underpayment not claimed to be due to negligence, I agree with the court that it would be absurd to let the Commissioner calculate the negligence penalty by applying the statutory percentage to the sum of the negligent and non-negligent underpayments. The absurdity is compounded where, as here, it is a close question whether the non-negligent "underpayment" was an underpayment at all. The Tax Court clearly erred in failing to limit the measure of the negligence penalty to the underpayment that was negligent.

With respect to Part III of the court's opinion, I agree that the temporary and rather insignificant increase in the taxpayer's raw material inventories was probably not sufficient, in itself, to justify a forced change in accounting methods. I concur in the court's conclusion on this point notwithstanding that the regulations, if they may be enforced in accordance with their terms, would apparently require the use of accrual accounting by anyone engaged in the kind of business in which this taxpayer was engaged.

The Commissioner's argument, as I understand it, boils down to this:

— 26 C.F.R. § 1.471-1 says that "inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor;"

— 26 C.F.R. § 1.446-1(c)(2)(i) says that "[i]n any case in which it is necessary to use an inventory the accrual method of accounting must be used . . . ."

— The production, purchase, or sale of merchandise is unquestionably an income-producing factor in the case at bar, so this taxpayer is automatically required to use the accrual method of accounting.

The Commissioner's logic seems unassailable on its face, but if we look beyond the language of the regulations I think we shall see several problems with the Commissioner's conclusion.

In the first place, the result produced here by a strict application of the regulations is hard to reconcile with the statute. 26 U.S.C. § 446(a) provides, subject to only two exceptions, that taxable income "shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." The law thus "plainly recognizes" that, as this court has repeatedly declared, "the selection of the system or method of keeping his books is primarily for the taxpayer." *Morris-Poston Coal Co. v. Commissioner of Internal Revenue*, 42 F.2d 620, 621 (6th Cir. 1930); *Glenn v. Kentucky Color & Chemical Co.*, 186 F.2d 975, 977 (6th Cir. 1951). The Secretary of the Treasury, and the Commissioner as his designee, have discretion to require the use of a particular method of accounting only where "no method of accounting has been regularly used by the taxpayer" (a situation that does not obtain here) or where "the method used [by the taxpayer] does not clearly reflect income." 26 U.S.C. § 446(b). Except where one of those two conditions has been shown to exist, the taxpayer enjoys an express statutory right to elect to "compute taxable income under . . . the cash receipts and disbursements method." 26 U.S.C. § 446(c).

Given that statutory right, I do not see how the regulations can be permitted automatically to require this taxpayer to use an accrual method of accounting unless we are prepared to accept the proposition that the Commissioner, by regulation, has made a valid determination that the cash method

of accounting "does not clearly reflect income" in *any* case in which the production, purchase, or sale of merchandise is an income-producing factor. Such a determination would seem overbroad, particularly when we recall it is beyond dispute that the cash method of accounting *did* clearly reflect the income of this very taxpayer prior to 1973.

In the second place, although the Tax Court may in this instance have accepted the Commissioner's argument that as a matter of regulatory law the cash method can never clearly reflect any merchant's income, the Tax Court has frequently refused to construe the regulations in such absolute terms. As the Court of Appeals for the First Circuit pointed out in *Wilkinson-Beane, Inc. v. Commissioner of Internal Revenue*, 420 F.2d 352 (1st Cir. 1970) (a case the holding of which would require affirmance of the Tax Court's decision here for other reasons):

> "The Tax Court, in a variety of contexts, has recognized that the presence of inventories does not necessarily mean that the cash basis does not clearly reflect income. *See, e.g.*, Ezo Products, Co., 37 T.C. 385, 393 (1961); Estate of Howard T. Roe, 36 T.C. 939, 952 (1961); Michael Drazen, [34 T.C. 1070] at 1079 [(1960)]; Stanford R. Brookshire, 31 T.C. 1157, 1166 (1959), *aff'd*, 273 F.2d 638 (4th Cir.), *cert. denied*, 363 U.S. 827, 80 S.Ct. 1597, 4 L.Ed.2d 1523 (1960); Theodore H. Beckman, 8 B.T.A. 830, 831 (1927); 2 J. Mertens, Law of Federal Income Taxation § 16.03, at 6 (Malone rev. ed. 1967); *contra* Harry Hartley, 23 T.C. 353, 358 (1954)." 420 F.2d at 355-56, n.9.

In the third place, the testimony of the only witness offered by the Commissioner in this case flatly contradicts the reading of the regulations for which the Commissioner now contends. Notwithstanding that this taxpayer has always been engaged in the production, purchase, or sale of merchandise, and notwithstanding that it has thus always been "necessary

[for this taxpayer] to use an inventory," the witness testified that "so long as the accounts that affect the difference between the cash receipts and disbursements method and the accrual method do not change materially, *they could stay on* [*the cash*] *method.*" (Emphasis supplied.)

Therefore, notwithstanding the seemingly unambiguous language of the regulations, I concur in the judgment that the regulations relating to inventories may not be construed in the absolute terms adopted by the Commissioner and the Tax Court.

This brings me to the question whether we must uphold the Commissioner's finding that the cash method did not clearly reflect this taxpayer's post-1973 income because of the presence of significant accounts receivable in 1974 and subsequent years. I would be inclined to answer this question differently than the court has done.

This taxpayer had accounts receivable on its books at the end of the 1974 tax year, to be sure, but that was true of tax years before 1974 as well. Unless all its sales were made C.O.D., the business could always be expected to have accounts receivable at year end, with the result that its income in any given year, computed on a cash basis, could always be expected to differ from the income that would be reflected for that year under an accrual method of accounting. The differences ought to wash out over the life of the business, of course, and the mere existence of a difference, in a particular year, could not mean that either method failed clearly to reflect income. If Congress had intended otherwise it almost certainly would not have required taxable income to be computed under the accounting method regularly employed by the taxpayer, as opposed to requiring anyone engaged in the production, purchase or sale of merchandise to use an accrual accounting method. Neither would Congress have said, as it did say in 26 U.S.C. § 446(c), that a taxpayer "may" use "any" of a list of accounting methods headed, rather conspicuously, by the cash method. As the Tax Court has reminded

us in this very case, the Commissioner "has no authority to force a taxpayer to change from a method which does clearly reflect income to another method which in his opinion more clearly reflects income;" and the statute, as this court declared in *Glenn v. Kentucky Color & Chemical Co.*, 186 F.2d 975, 977, *supra*, does not require of the taxpayer's accounting method "absolute precision."

It is true that because of the cash crunch experienced by the taxpayer's customers as a result of the Arab oil embargo, the taxpayer's accounts receivable—which, as the court acknowledges, were not negligible before 1974—had increased greatly by the end of 1974, and had not shrunk even to their former size by the end of 1976. Under the taxpayer's cash accounting method, however, the decline in the taxpayer's income was less than it otherwise would have been because of a partially offsetting increase in the taxpayer's accounts payable. Just as the taxpayer's customers were taking longer to pay their bills, so the taxpayer was taking longer to pay its own bills—and under the cash method of accounting, the latter circumstance obviously worked to the advantage of the tax collector.

As the following chart shows, there was roughly a threefold increase in both the taxpayer's accounts receivable and its accounts payable between the beginning of 1974 and the end of 1976:

	1/1/74	12/31/76
Accounts Receivable	$72,304.59	$238,689.53
Accounts Payable	28,700.82	84,215.35

At the end of 1976, the gap between the taxpayer's accounts receivable and its accounts payable had increased by only $110,870.41; yet the accounting change imposed by the Commissioner caused a $258,075.63 jump in the taxpayer's 1974 income. The change in accounting methods thus boosted the

taxpayer's income for that one year by more than 230% of the increase in the taxpayer's accounts receivable, net of accounts payable, over the entire three year period.

This result, as the court suggests, seems harsh. It seems especially so when we recall that the reason the taxpayer is being required to pay substantially *more* in taxes for 1974 is that it received substantially *less* in actual cash revenues that year. Recognizing, as we must, that the way in which this taxpayer was applying its regular accounting method was unquestionably correct (a circumstance that sharply distinguishes this case from *Commissioner of Internal Revenue v. Hansen*, 360 U.S. 446 (1959), where accrual basis taxpayers were using accrual accounting in a way which was highly questionable under the statute and which "might well [have afforded] opportunities to accrual basis taxpayers to allocate income to years deemed most advantageous" (360 U.S. at 467)), it is hard to avoid the conclusion that the curbstone equities favor the taxpayer here.

This taxpayer is also aided, I believe, by the holding of this court in *Morris-Poston Coal Co. v. Commissioner of Internal Revenue*, 42 F.2d 620 (6th Cir. 1930), a case which is closely analogous to this case on its facts. There, as here, the taxpayer was on a cash accounting basis. At the end of the year 1921 the taxpayer had on its books a $108,000 receivable that would have been included in 1921 income had it been paid when due; because of a business depression, however, there was some delay in payment and the taxpayer did not actually receive the money until 1922. The Commissioner insisted that the account owed the taxpayer at the end of 1921 should have been accrued as 1921 income, just as he insisted that the money owed the taxpayer in this case at the end of 1974 should have been accrued as 1974 income. This court pointed out, in *Morris-Poston*, that the Commissioner's right to compel the taxpayer to account for the $108,000 as 1921 income, even though the money was not actually received in that year, "stands upon the Commissioner's preliminary finding that

the method employed by the taxpayer did not clearly reflect the income." The Commissioner did not deny that the taxpayer's 1921 tax return clearly reflected its 1921 income, said the court, "*unless for the fact that it contemplated assigning to the year 1922 this [$108,000] income, which was in fact received in that year.*" 42 F.2d at 621. (Emphasis supplied.) "The only question," the court concluded, "is whether the [return] truly reflected the taxpayer's income for 1921; and we think it did." 42 F.2d at 623.

The Commissioner did argue, unsuccessfully, that the taxpayer in *Morris-Poston* had changed its method of accounting without prior approval, but that fact does not distinguish *Morris-Poston* from this case if it was also the Commissioner's position, as it seems to have been, that the taxpayer's accounting method did not clearly reflect the taxpayer's income for 1921.

This court did not, in *Morris-Poston*, explicitly follow the decision handed down earlier that year in *Osterloh v. Lucas* 37 F.2d 277 (9th Cir. 1930). In *Glenn v. Kentucky Color & Chemical Co.*, 186 F.2d 975, *supra*, however, (a per curiam opinion by Chief Judge Hicks and Circuit Judges Simons and Allen), this court did cite *Osterloh* in support of the proposition that "[t]he statute requires *only* that the taxpayer's books shall be kept fairly and honestly, without any attempt to evade the tax." 186 F.2d at 977. (Emphasis supplied.) There may be much to be said for the position, advanced in *Caldwell v. Commissioner of Internal Revenue*, 202 F.2d 112 (2d Cir. 1953), and *Wilkinson-Beane, Inc. v. Commissioner of Internal Revenue*, 420 F.2d 352, *supra*, that the statute does not require "only" that the books be kept fairly and honestly, but also requires, as the *Wilkinson-Beane* court put it, that the taxpayer's accounting method reflect his income "with as much accuracy as standard methods of accounting permit." 420 F.2d at 356. That position is contrary to the one taken by this court in *Glenn*, however, as *Wilkinson-Beane* noted (see 420 F.2d at 356, n.12), and I am not sure

we ought to follow *Wilkinson-Beane* without explicitly overruling our decisions in *Glenn* and *Morris-Poston*.

Osterloh, the Ninth Circuit decision applied by this court in *Glenn*, was a case in which the Commissioner required the taxpayer to continue to adhere to the cash method of accounting where the use of that method happened to work to the Commissioner's advantage. The reasons given by the court in upholding the Commissioner are instructive:

> "The method of accounting regularly employed by the petitioner [the cash receipts and disbursements method] is a recognized one within the meaning of the act, and should be accepted as controlling unless such method does not clearly reflect the income.
>
> . . .
>
> If [the requirement that the method of accounting clearly reflect income] is absolute, it is safe to say that the books kept on the basis of cash received and disbursed will rarely, if ever, reflect the true income, because nearly always at the end of a tax year accounts due the taxpayer will remain uncollected and some of his own obligations will remain unpaid. But *we do not think that any such literal construction was contemplated.* In our opinion, all that is meant is that the books shall be kept fairly and honestly; and when so kept they reflect the true income of the taxpayer within the meaning of the law. In other words, the books are controlling, unless there has been an attempt of some sort to evade the tax. *This construction may work to the advantage of the taxpayer or the government at times, but if followed out consistently and honestly year after year the result in the end will approximate equality as nearly as we can hope for in the administration of a revenue law.*" 37 F.2d at 278-79. (Emphasis supplied.)

Citing *Wilkinson-Beane, Inc. v. Commissioner*, ¶ 69,079 P-H Memo T.C. (1969), *aff'd.* 420 F.2d 352 (1st Cir. 1970),

the opinion of the Tax Court in the instant case says that "[t]he test in *Osterloh v. Lucas* has been narrowed by code changes and by new regulations and does not apply where the production, purchase, or sale of merchandise is an income-producing factor and where it has been determined that income is not clearly reflected in petitioner's method." I do not think this will wash in a circuit in which *Morris-Poston* and *Glenn* still constitute binding precedent. As to the "code changes" of which the Tax Court speaks, I know of none that is relevant. As to the regulations on the taxation of businesses in which the production, purchase or sale of merchandise is an income-producing factor, we have seen that these regulations are not controlling here. And as to the Commissioner's determination that "income is not clearly reflected in petitioner's method," the validity of that determination is precisely what we are to decide—and the logic of *Osterloh v. Lucas*, like the logic of *Morris-Poston* and *Glenn*, says that this determination must not be permitted to stand.

Accordingly, and with respect, I dissent from the court's decision to uphold the Commissioner's determination. I would reverse the decision of the Tax Court insofar as it denies the taxpayer the right to calculate its 1974 income under the method of accounting regularly used in prior years, and I would hold for the Commissioner on his protective cross-appeal from the Tax Court's decision that the taxpayer overpaid its 1975 and 1976 income taxes.

Appendix D

UNITED STATES TAX COURT

Docket No. 6758-78

ASPHALT PRODUCTS CO., INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the opinion of the Court filed April 24, 1984, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioner for the taxable year 1974 in the amount of $133,248.69;

That there is an overpayment in income tax for the taxable year 1975 in the amount of $2,415.80, which amount was paid on March 15, 1976, and for which amount a claim for refund could have been filed, under the provisions of I.R.C. section 6511(b)(2), on March 23, 1978, the date of the mailing of the notice of deficiency;

That there is an addition to the tax due from the petitioner for the taxable year 1974, under the provisions of I.R.C. section 6653(a), in the amount of 46,943.37;

That there is no addition to the tax due from the petitioner for the taxable year 1975, under the provisions of I.R.C. section 6653(a).

(Signed) Leo H. Irvin
Judge
Entered: SEP 27 1984

Appendix E

UNITED STATES TAX COURT

T. C. Memo. 1984-208

J. CLARK AKERS, III AND ELEANOR M. AKERS, et al.,[1]
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket Nos. 6717-77, 6729-77, 6734-78, 6758-78, 6759-78, 5873-80, 5874-80, 5875-80, 5876-80,

Filed April 24, 1984.

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Mark H. Westlake and *Ervin M. Entrekin*, for the petitioners.

John L. Hopkins and *Robert B. Nadler*, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

IRWIN, *Judge:* In these consolidated cases, respondent determined deficiencies in petitioners' Federal income taxes and additions to tax as follows:

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[1] Cases of the following petitioners are consolidated herewith: William B. Akers and Jo Ann Akers, docket Nos. 6729-77, 6759-78, 5876-80; Estate of James C. Akers, Estelle L. Akers, Executrix and Estelle L. Akers, docket No. 5874-80; and Asphalt Products Company, Inc., docket Nos. 6758-78 and 5873-80.

Docket Nos.	Petitioners	Year	Income Tax Deficiency	Addition to Tax Sec. 6653(a)[2]
6758-78	Asphalt Products Company, Inc.	1974	154,332.16	$7,716.61
		1975	7,151.98	357.60

After concessions by petitioners and respondent,[3] the issues remaining for our decision are:

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(2) whether Asphalt Products Company, Inc. properly reported income using the cash basis method, or whether it must use the accrual method of accounting;

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FINDINGS OF FACT—GENERAL

Some of the facts have been stipulated. The written and oral stipulations, together with the attached exhibits, are incorporated herein by this reference.

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[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue and all references to Rules are to the Tax Court Rules of Practice and Procedure.

[3] For the taxable year 1974, with respect to the notice of deficiency dated March 23, 1978, Asphalt Products Company, Inc. concedes adjustment (f) in the amount of $1,103.04. With respect to the statutory notice for 1976 dated January 25, 1980, Asphalt Products company, Inc., concedes adjustment (f) in the amount of $298.50 and adjustment (g) in the amount of $213.49. With respect to these statutory notices, respondent and Asphalt Products Company, Inc. have agreed to compromise the adjustment marked as adjustment (b) with respect to travel and entertainment expenses for the years 1974 through 1976 as follows: 1974, $7,065.38; 1975, $6,293.27; 1976, $5,096.58.

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Petitioner Asphalt Products Company, Inc. (hereinafter referred to as Asphalt Products) is a corporation with a principal place of business in Nashville, Tennessee at the time its petitions were filed. Its corporate Federal income tax returns for the calendar years 1974 through 1976 and an amended return for 1976 were filed with the Memphis Service Center, Memphis, Tennessee.

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For organizational purposes, we have found facts separately for some issues in these consolidated cases. However, as certain facts are relevant to more than one issue, they may be used as a basis for resolution of more than one issue.

FINDINGS OF FACT—SPECIFIC

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II. Method of Accounting used by Asphalt Products

Asphalt Products (petitioner) is a producer of emulsified asphalt.[6] Emulsified asphalt, a product used in paving roads, is manufactured from pure asphalt using a chemical treatment and physical process. Emulsified asphalt is preferable to pure asphalt in road paving because it can be spread at much lower temperatures, resulting in energy savings in preparation and application.

Originally, Asphalt Products bid on road paving jobs and when a bid was successful, it prepared the emulsion and subcontracted the paving job to the Globe Company, Inc. (Globe), a road contracting company incorporated in 1959.

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[6] We include a description of the various branches of the business of Asphalt Products only insofar as is relevant to the issues under our consideration.

All stock of Globe was owned by the Globe Company Partnership (Globe Partnership), which after 1965, was owned by William and Clark. In 1971, Globe sold its principal operating assets and its name was changed to Akers, Inc. The Globe Partnership, however, was not dissolved. Subsequently in 1973, Akers, Inc. transferred its assets to Asphalt Products. After this time, Asphalt Products was in the contracting business.

Very little road contracting work is done by Asphalt Products in the colder months of December, January, and February. Asphalt Products generally closed its operations completely in mid-December, and all employees took vacations from mid-December until early January.

Emulsified asphalt solidifies when not kept warm and is ruined when it freezes. Consequently, Asphalt Products did not keep any finished product in its tanks during the two-week shutdown period. The company sold its finished product prior to the plant shutdown, leaving no yearend inventory of finished product. Furthermore, Asphalt Products generally did not have a significant stockpile of raw materials in mid-December, because sales of its products slowed during wintertime, increasing again around the beginning of March.

This general inventory-clearing procedure changed in 1973 due to the Arab embargo on oil sales to the United States. Asphalt emulsion raw materials are derived from oil refining-process residue. The oil-refining company suppliers of Asphalt Products indicated that it had to purchase its quota by a certain date to assure the availability of raw product in a subsequent year. Asphalt Products was, therefore, obliged to maintain some inventories of raw material at year-end.

Several Tennessee counties, customers of Asphalt Products, were also affected by the embargo. Previously, the price of the asphalt emulsion rose only from 11 cents per gallon in 1951 to 14 cents in 1973. In 1974, the price rose

to 28 cents and by 1982, the price was 75 cents per gallon. As the price rose, gasoline consumption declined. Because the counties received a portion of their funding for road work from a two-cent per gallon gasoline tax, they had difficulty meeting payments owed on work for which they have contracted in previous years. Thus, Asphalt Products' accounts receivables increased.

Asphalt Products always reported its Federal income tax liability on the cash basis method of accounting. Its books are maintained on a cash receipts and disbursements basis. With regard to the asphalt portion of the business, work papers are prepared in the form of balance sheets and list accrual accounts for the company. These workpaper balance sheets were instituted so that the company management could keep track of cash flow during their busy months.

Figures available in the books, records, and workpapers of Asphalt Products showed the following accrual account balances for January 1, 1974 through December 31, 1976:

	1-1-74	12-31-74	12-31-75	12-31-76
Inventory	$16,453.76	$ 25,812.83	$36,374.86	$ 1,583.00
Accounts Receivable	71,482.09	264,269.42	256,078.17	237,991.75
Accounts Receivable-Inspection	822.50	425.81	523.30	697.78
Accounts Payable-Trade	27,892.83	9,567.36	63,227.53	82,626.55
Accounts Payable-Royalties	435.31	270.02	297.25	136.96
Accounts Payable-Sales Taxes	372.68	156.34	220.52	1,451.84

The difference between taxable income shown on returns filed by Asphalt Products for the years at issue, and taxable income as calculated by respondent under the accrual

method, taking into account appropriate adjustments is compared in the following chart:

	1974	1975	1976
Taxable income on return	$117,803.55	$ 37,963.51	$ 38,780.20
Taxable income on statutory notice	439,497.44	59,383.32	80,339.13
Adjustment to taxable income based on change of accounting method	280,514.34	(51,283.31)	(73,173.85)
Taxable income taking into account 10-year spread forward	375,879.18	35,727.87	10,704.74

In 1974, Asphalt Products received about $120,000 as its portion of a judgment from a lawsuit concerning the collection of a contract amount dating back to 1967. Taxes were paid when the judgment was received, according to the cash method practice.

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Opinion

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II. Issue 2-Correct Method of Accounting

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Permissible methods for computing taxable income include the cash receipts and disbursements and the accrual methods. Section 446(c). An exception, however, is provided under section 446(b) whereby, when the method used by a taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as in the opinion of the respondent does

clearly reflect income. See section 1.446-1(b)(1), Income Tax Regs. Respondent has broad discretion in determining whether a taxpayer's method clearly reflects income. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979); *United States v. Catto*, 384 U.S. 102 (1966); *Commissioner v. Hansen*, 360 U.S. 446, 467 (1959). Moreover, the taxpayer has a heavy burden in overcoming respondent's determination. *Thor Power Tool Co. v. Commissioner, supra; Lucas v. Structural Steel Co.*, 281 U.S. 264, 271 (1930); *Brooks-Massey Dodge, Inc. v. Commissioner*, 60 T.C. 884, 889 (1973). The standard used is that respondent's determination must not be interfered with unless clearly unlawful or plainly arbitrary. *Thor Power Tool Co. v. Commissioner*, 439 U.S. at 532-533.

Inventory must be accounted for in a taxpayer's method of accounting. Section 1.446-1(a)(4)(i), Income Tax Regs. provides:

> (i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. * * *

Additionally, with respect to the provision in section 446(c) allowing the use of either cash or accrual method, a special rule is included in the regulations whereby, when it is necessary to use an inventory, the accrual method of accounting must be used with regard to purchases and sales, unless otherwise authorized under section 1.446-1(c)(2)(ii), Income Tax Regs. Section 1.446-1(c)(2)(i), Income Tax Regs., provides:

> In any case in which it is necessary to use an inventory the accrual method of accounting *must* be used with regard to purchases and sales unless

> otherwise authorized under subdivision (ii) of this subparagraph. [Emphasis supplied.]

Section 1.446-1(c)(2)(ii), Income Tax Regs., provides in part:

> [T]he Commissioner *may* authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. * * * [Emphasis supplied.]

Petitioner has accounted for its inventory within its method of accounting, the cash method, and contends that the cash basis method of accounting did clearly reflect its income during the years at issue. In maintaining this position, petitioner relies on the standard set forth in *Osterloh v. Lucas*, 37 F.2d 277 (9th Cir. 1930), and contends that it is entitled to use the cash method because it had consistently, fairly, and honestly kept its books using this method. Petitioner additionally argues that the cases on which respondent relies are contrary to the meaning and intent of section 446, and that inventory was not a material item in reflecting the income of Asphalt Products, Inc.

Respondent, relying on his broad authority under section 446(b) to reject a method of accounting that does not clearly reflect income, argues that Asphalt Products must switch to the accrual method of accounting. Respondent maintains the accrual method is called for because inventory is a material income-producing factor in the business of petitioner Asphalt Products, and because business practices had changed so that as of 1974, the cash receipts and disbursements method of accounting did not clearly reflect petitioner's income.

We agree with respondent that petitioner must change its method of accounting.

Petitioner has used the cash method of accounting to report its income from the inception of its business. Petitioner argues that because respondent had no previous objections to the use of this method, it is entitled to continue its use.

Where respondent has accepted a method of accounting over a long period of years, this fact is given weight in determining whether respondent was justified in changing the method used by such taxpayer *Ezo Products Co. v. Commissioner*, 37 T.C. 385, 391 (1961); *Geometric Stamping Co. v. Commissioner*, 26 T.C. 301 (1956). It does not, however, preclude a determination that another method must now be used. The authority to order a change in accounting method where a longstanding method is in use depends on the validity of respondent's finding that a taxpayer's method does not clearly reflect income. *Ezo Products Co. v. Commissioner, supra; Glenn v. Kentucky Color & Chemical Co.*, 186 f.2d 975, 977 (6th Cir. 1951). Respondent has broad powers in determining whether an accounting method clearly reflects income, but has no authority to force a taxpayer to change from a method which does clearly reflect income to another method which in his opinion more clearly reflects income. *Bay State Gas Co. v. Commissioner*, 75 T.C. 410, 417 (1930), affd. 689 F.2d 1 (1st Cir. 1982); *Auburn Packing Co. v. Commissioner*, 60 T.C. 794, 800 (1973); *Garth v. Commissioner*, 56 T.C. 610, 623 (1971). Thus the success of petitioner's contention that it is entitled to use the cash method turns on whether the cash method clearly reflects petitioner's income.

For all years at issue, petitioner was in the business of manufacturing and selling asphalt and asphalt products and performed some paving work via its contracting business. Corporate books show balances reflecting inventories and accounts receivable. It is evident under the facts of this case that the production, purchase and sale of emulsified asphalt is an income-producing factor in petitioner's business and, therefore, that merchandise on hand, in-

cluding oil byproducts and other raw materials, must be taken into account in computing the taxable income of petitioner. See sec. 1.446-1(c)(2)(i), Income Tax Regs.

During the years at issue, petitioner of necessity maintained inventories of the raw materials used in its asphalt emulsion business. Because it was necessary to maintain inventories, petitioner's income could not be clearly reflected by the use of the cash method. Inventory is a material income-producing factor in petitioner's business.[13] Furthermore, the fluctuation in accounts receivable is substantial in relation to petitioner's income. *See* Ezo Products Co. v. Commissioner, 37 T.C. at 392. We think the evidence in the record is sufficient to show that respondent's determination that the cash receipts and disbursements method does not clearly reflect petitioner's income is not clearly arbitrary or unreasonable. Accordingly, we are compelled to find that respondent did not abuse his discretion in arriving at his conclusion. *Thor Power Tool Co. v. Commissioner*, 439 U.S. at 532-533. Furthermore, there was no showing of respondent's active acceptance of a past method of accounting in the present case and, therefore, the factual situation in *Magnon v. Commissioner*, 73 t.C. 980 (1980), is distinguishable. The "fair and honest" standard of *Osterloh v. Lucas*, *supra*, is similarly inapplicable in the present case. The test in *Osterloh v. Lucas* has been narrowed by code changes and by new regulations and does not apply where the production, purchase, or sale of merchandise is an income-producing factor and where it has been determined that income is not clearly reflected in petitioner's method.[14] We hold, therefore, that

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[13] The presence of temporary inventory "blips" and higher accounts receivable than in pre-1974 years indicates that the underlying nature of petitioner's business has changed from the earlier, less volatile and less inflationary years.

[14] See *Wilkinson-Beane, Inc. v. Commissioner*, T.C. Memo. 1969-79, affd. 420 F.2d 352 (1st Cir. 1970).

petitioner must change its method of accounting to an accrual method.

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Due to concessions,

Decisions will be entered under rule 155.

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